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China's Exchange Rate System after
WTO Accession: Some Considerations

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Contents

Abstract	4
1 Introduction	5
2 China's exchange rate policy and capital control regime	5
2.1 China's current exchange rate policy	5
2.2 China's capital account control regime	7
3 Choosing the right exchange rate regime for China	9
3.1 Exchange rate regimes	9
3.2 China's fixed exchange rate regime	9
3.3 Floating exchange rate regimes	11
3.4 Intermediate arrangements: the crawling peg and floating within a band	12
4 Liberalisation of capital controls in China	13
4.1 Capital controls still needed	13
4.1.1 The "second-best" argument	13
4.1.2 Increased financial risk in the financial system	13
4.1.3 Assistance for monetary and fiscal policies	14
4.2 The need to ease controls	14
4.2.1 China's opening policy and integration into the global economy	14
4.2.2 Current difficulties in the capital control regime	15
4.2.3 Liberalisation of financial market inevitable	16
4.3 Liberalising capital controls	17
5 Conclusions	17
References	19
Notes	21

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Abstract

China's foreign exchange system currently combines a virtual peg to the US dollar with direct capital account controls. With accession to the World Trade Organisation, China's capital control regime can be expected to lose its effectiveness in the face of accelerating liberalisation of trade and investment. While the country may experience in the medium term an increase in nominal and real shocks, the easing of capital controls is an inevitable requisite promoting development of China's domestic financial markets and integration with the global trade system and capital markets. Soft pegs with wide fluctuation bands or similar arrangements that retain certain capital controls could thus be adopted in the interim. Then, as China's financial markets develop and enterprises and banks begin to adhere consistently to market principles, a more flexible foreign exchange regime such as a managed float with relaxed capital controls could be introduced.

Keywords: China, exchange rate system, WTO accession

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1 Introduction

The IMF officially registers China as having a managed floating exchange rate, but its foreign exchange system might be better characterised as a virtual peg to the US dollar combined with comprehensive, direct capital account controls.

When China abolished its dual exchange rate regime in 1994, it implemented significant reforms in its foreign exchange system and abolished the right of domestic enterprises to retain their foreign exchange earnings. The old system was replaced with compulsory foreign exchange settlement. Domestic enterprises had to sell their foreign exchange earnings to designated banks, but could purchase foreign currency as long as they furnished proof of commercial contracts. In 1996, the China's monetary authorities extended the foreign exchange settlement system to encompass foreign investment firms. These firms were allowed them to keep their foreign exchange earnings. At the end of 1996, China reached an important milestone by permitting official renminbi (RMB)¹ convertibility under current accounts.

Since the beginning of 1994, China's exchange rate has been determined in the China Foreign Exchange Trading Centre (CFETC), an inter-bank foreign exchange market. The RMB initially launched at an exchange rate of RMB 8.7 to the dollar. After allowing a modest appreciation, China's central bank, the People's Bank of China (PBOC), has actively sought to hold the exchange rate at around RMB 8.3 to the dollar.

China's fixed exchange rate policy is supported by an elaborate system of direct capital account controls implemented through administrative measures. Although China has consistently encouraged foreign direct investment (FDI), it has also severely restricted foreign portfolio investment and short-term foreign borrowing. The result is that China's foreign debt structure is dominated by medium- and long-term borrowing. In 1996 and 1997, China was still optimistic about full convertibility of the RMB. The central bank even announced a plan to achieve full convertibility in the early 2000s. The Asian crisis crushed this hope and forced the central bank to make currency stability its primary exchange rate policy objective.

Given the underdeveloped state of China's financial markets and ongoing need for improving corporate governance, currency stability and avoidance of adverse impacts of capital flows should remain central policy objectives for years to come. However, when China joins the WTO, liberalisation of trade and investment will accelerate and cause China to experience an increase in nominal and real shocks. Nevertheless, the easing of capital controls is necessary for the development of China's domestic financial markets and integration of China into global trade and capital markets. During the transition, a "soft" peg with wide fluctuation bands or a similar arrangement that retains some capital control measures could be adopted. Eventually, as China's financial markets mature and enterprises start to conform consistently to market principles, a flexible foreign exchange regime such as a managed float with relaxed capital controls could be introduced.

2 China's exchange rate policy and capital control regime

2.1 China's current exchange rate policy

China's old dual exchange rate system allowed a market swap rate and an official rate to exist side by side.² When the system was phased out at the end of 1993, the official exchange rate stood at RMB 5.8 to the dollar while the market swap rate was RMB 8.7 to the dollar. The 1994 reform applied the market swap rate as the base rate, which, on paper, meant that the

Chinese currency was devalued around 50 %. In fact, the devaluation was far less substantial as most foreign exchange settlements were already based on the market swap rate.

Other measures in the 1994 overhaul of the foreign exchange system included the above-mentioned compulsory foreign exchange settlement system. Initially, all foreign exchange earnings by domestic enterprises had to be sold to designated banks and domestic enterprises had to show proof of commercial contracts to buy foreign exchange. The system of approvals for use of foreign exchange on current accounts was abolished. Firms without exemptions were required to remit their foreign exchange earnings to China.

Since 1996, China's exchange rate regime has operated as a currency peg system with the exchange rate fixed at around RMB 8.3 to the dollar.³ At that time, the central bank enlarged the foreign exchange settlement system to encompass foreign investment firms. While these firms were allowed to keep their foreign exchange earnings and determine their foreign exchange portfolio, other domestic firms were still barred from retaining their foreign exchange earnings.⁴ China's monetary authorities also allowed limited purchase of foreign exchange by households. After a series of measures to ease restrictions on foreign exchange trading under other current account items, China officially achieved RMB convertibility under current accounts at the end of 1996.

China's foreign exchange system reform included the inauguration in April 1994 of an inter-bank foreign exchange market, the China Foreign Exchange Trading Centre (CFETC). Since foreign exchange swap markets were abolished at the end of 1998, all foreign exchange trading has been conducted in this market. The CFETC also provides settlement services. China's central bank, the People's Bank of China (PBOC), currently recognises over 300 foreign exchange banks and non-banking financial institutions as market members.

The PBOC maintains an open-market operations room at the Centre to intervene in the foreign exchange market as needed. Designated foreign exchange banks are assigned individual foreign exchange margins. They must enter the market whenever they exceed their margin limits.

Share of foreign exchange market during 1-10/1999		
	Buy	Sell
Chinese banks	60.0%	81.1% *
Foreign banks	11.6%	18.5%
Central bank	28.4%	-

* The PBOC accounts for over 50% of selling.

Source: China Financial development report, 2000

As capital account controls are relaxed, the foreign exchange market will play a growing role in determining the exchange rate of the RMB. The PBOC, in turn, will shift from acting as rate-setter to a supervisory role.

The following problems currently hamper China's foreign exchange market:

- Only financial institution headquarters hold CFETC memberships.
- The market is dominated by the PBOC and three wholly state-owned banks. The central bank plays a huge role in dictating the course of the exchange rate.

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- The compulsory foreign exchange settlement system and other regulations suppress supply and demand for foreign exchange. As a result, enterprises and banks find it difficult to ascertain their optimal foreign exchange positions. Moreover, designated foreign exchange banks are limited by foreign exchange quotas set by the State Administration of Foreign Exchange (SAFE). As there are strict controls on foreign borrowing, the total amount of foreign exchange in the market is limited, and largely dictated by the current account situation. Since China enjoys current account and capital account surpluses, the supply of foreign exchange has tended to exceed demand. The resulting appreciation pressure on the RMB compels the PBOC to buy large amounts of foreign exchange to stabilise the exchange rate.
 - The current foreign exchange market consists of a physical market (the CFETC) and a non-physical market (deals between CFETC members and their customers). The physical market dominates, and is characterised by public quotations and CFETC-organised deals. Its drawbacks are high costs and restrictions such as official trading hours and geographical location.⁵
 - The products traded on the CFETC tend to be extremely simple. Only three foreign currencies are traded: the US dollar, the Hong Kong dollar (HKD) and the Japanese yen (JPY). There is no other currency trading or trading in futures and options based on the three foreign currencies.⁶

2.2 China's capital account control regime

SAFE administers an elaborate system of direct capital account controls. It imposes the following regulations control cross-border capital flows:

- Capital brought in from abroad must be deposited in special accounts in designated banks. Any repayments and remittances from these accounts are also subject to SAFE approval.
- Foreign investment in the Chinese stock market is limited to B shares. Inbound foreign capital must get SAFE approval to convert to RMB.
- All long-term foreign borrowing (over one year), including project loans, must be mentioned in the comprehensive state commercial loan plan. These loan contracts need to be approved by SAFE, which assesses the core contents of all mid- to long-term commercial loans. Based on the financial institution's assets and liability condition, SAFE can suggest a distribution plan among various financial institutions, and set individual foreign exchange loan ceilings for each financial institution.
- For short-term foreign debts (less than or equal to one year), SAFE assigns foreign debt balance quotas to designated financial institutions. Each financial institution can borrow from abroad, under supervision, without loan-by-loan approval of local SAFE branches.
- For commercial loans of less than three months under current accounts, SAFE approval is not required. Commercial loans of longer than three months but less than or equal to

one year have to be registered with SAFE, and the conditions for repayment of principal and interest rates must be approved by SAFE.

- Only PBOC-approved state organisations can issue bonds abroad. The size of these issues is determined in accordance with the state foreign capital utilisation plan.
- Leasing and trust loans from abroad are subject to local- and national-level plans for technological upgrades and foreign capital utilisation. Such loans may not exceed the foreign exchange quotas set for the enterprises involved and must be registered with SAFE.
- All foreign loan guarantees require SAFE approval. Only authorised financial institutions and enterprises are allowed to provide foreign exchange loan guarantees. The amounts to be guaranteed are subject to strict conditions.
- Outbound foreign investments by domestic enterprises must receive SAFE approval. China's foreign debt structure is dominated by medium- and long-term foreign debt. Short-term foreign capital inflows usually are part of commercial deals. State sovereignty debts are significant.

China's foreign debts that were registered with SAFE in June 1999, USD billion		
Total debts	148.8	100%
Over one year	131.7	88.5%
One year or less	17.1	11.5%
Sovereignty	43.0	28.9%
Financial institutions	42.0	28.2%
Foreign investment firms	47.1	31.7%
Domestic firms	14.9	10.0%
Others	1.8	1.2%

Source: China financial development report, 2000

In principle, enforcement of controls and retention of foreign exchange earnings depends on the size of the PBOC's foreign exchange reserves and pressures on exchange rates, but there are loopholes. For example, many of the foreign loans taken by international trust and investment companies (ITICs) in the early and mid-1990s were never approved or registered with SAFE.

3 Choosing the right exchange rate regime for China

3.1 Exchange rate regimes

The IMF recognises eight exchange rate system arrangements: common currency (arrangements with no separate legal tender), currency board, other conventional fixed pegs, pegged rate in horizontal band, crawling peg, rates within crawling bands, managed float with no pre-announced exchange rate path and independent floats. They are listed according to the “hardness” of the peg. Frenkel (1998) notes that no exchange rate system is optimal for all countries at all times. Rather, countries should carefully choose the optimal exchange rate systems, because it has important implications on the stability of their economy. The system they adopt depends greatly on their capital control regime and the level of development of their domestic financial markets.

The following table summarises the benefits and disadvantages of the four exchange rate regimes most relevant to China, i.e. fixed and floating regimes, as well as two intermediate arrangements.

Benefits and disadvantages of various exchange rate regimes (under free mobility of capital)		
	Benefits	Disadvantages
Fixed exchange rate regime	Stable currency High credibility	No monetary autonomy Powerless in dealing with shocks
Crawling peg	Relative stable currency Lets high-inflation countries avoid real exchange rate overvaluation	Low monetary autonomy and credibility Modest effectiveness against shocks Crawling rules difficult to design
Float within a band (target zone)	Restriction on wide currency swing Limited monetary autonomy Some flexibility in dealing with shocks	Vulnerable to speculative currency attacks Band definition is difficult
Floating exchange rate regime	Domestic-oriented monetary policy Exchange rate adjusts to deal with shocks	Currency risks to domestic banks and enterprises Wide fluctuations cause distortion

3.2 China's fixed exchange rate regime

A fixed exchange rate regime can help prevent wide fluctuations in exchange rates that can inhibit development of financial markets. Although wide swings of free-floating currencies are common in the international financial market, they may have an adverse impact on trade and investment in less-developed countries. In China's case, there is a potential threat to systemic stability posed by the lack of experience domestic firms, households and the central bank in dealing with currency risks.

Moreover, if the central bank lacks the credibility and independence to fight inflation, a fixed exchange rate can also be used as a nominal anchor. By pegging the currency to one of another country with more stable monetary environment, the country can import credibility to deal with inflation. Since the RMB was virtually pegged to the USD in 1996, China has successfully restrained inflation.

China's fixed exchange rate system has also caused problems, even without the liberalisation of capital account controls. As the currency is pegged to the US dollar, it is inflexible in the face of internal and external shocks, as well as exchange rate fluctuations between the USD and either the yen or the euro. Thus, Chinese enterprises and banks still need to hedge against currency risks related to other currencies. This problem is worst when there are wild fluctuations between USD and these currencies.⁷

During the Asian crisis, China's exchange rate had to be maintained to prevent further devaluation of many other Southeast Asian currencies. However, as Chinese exports suffered, the government resorted to measures such as raising the export rebate to stimulate exports. Thus, exchange rate stability was bought with the increased fiscal burden of tax rebates. The use of tax rebates to stimulate exports becomes highly problematic over time. In recent years, China has enjoyed current account surplus and a surge in FDI, which has put appreciation pressure on the RMB. When the central bank intervenes to maintain a stable exchange rate, it is forced to tighten the domestic money base.

With the liberalisation of trade and investment in coming years, China will most likely face an increase in nominal and structural shocks. The fixed exchange rate policy denies China of a vital tool for dealing with shocks and adjusting towards external balance. Thus, monetary and fiscal policies tend to be rather ineffective under large adverse shocks, when domestic prices and costs relative to foreign prices and costs must adjust. The possible resultant deflation is very painful and sometimes unbearable in the political economy. Indeed, China's deflation during recent years is partly attributable to an inability to adjust its exchange rate during the Asian crisis.

The simultaneous combination of free capital mobility, a fixed exchange rate regime and domestic-oriented monetary policy has been called the "impossible trinity" of monetary policy. For example, if the capital account is eased, a fixed exchange rate system requires the central bank to relinquish its autonomy in setting monetary policy. However, a domestic-oriented monetary policy is vital for China's economic and financial stability in the medium term for the following several reasons. First, fiscal policy will be constrained in the medium term, partly due to the expansionary stance of the past two years and the expected policy in the next two years. Fiscal deficits and government debts have expanded rapidly and thus have little room to expand much further in the next five years. Second, with the development financial markets and improvement in the management and internal control of financial institutions, monetary policy tools will gain potency in influencing macroeconomic activities. Thus, the easing of capital controls demands a flexible exchange rate policy.

Under a liberalised capital control regime, China would be susceptible to currency crises as long as it maintained a fixed exchange rate policy. Second-generation currency crisis theory emphasises the self-fulfilling nature of the crisis-making mechanism, which requires very solid domestic economic fundamentals and the elimination of time inconsistency of policymaking to fend off currency crises.⁸ Maintaining a fixed exchange rate policy thus depends not only on solid economic fundamentals, but also on the capability of the central bank to shape expectations in international capital markets. This task poses a serious challenge to China's policymakers.

Recent experience shows that, to maintain a currency peg under the condition of free capital mobility across national borders, a country needs a "hard" peg backed by a currency union or currency board. However, the requirements for the effective operation of either system, in terms of domestic economic fundamentals and soundness of the financial system, are very demanding. Furthermore, these two arrangements deprive the country of any possibility of adjusting to large external or internal shocks. Because China is large and not overly dependent on a specific trade partner, the costs of either arrangement will exceed their benefits for China.

3.3 Floating exchange rate regimes

A floating exchange rate regime can remedy many of the drawbacks of a fixed exchange rate regime. It allows a country to adjust to external and internal shocks. Devaluation can generally boost international competitiveness, even with a rapid rise in domestic wages and prices. Exchange rate movements act as a safety valve, adjusting to cross-border capital flows and differentials between international and domestic interest rates. Faced with shocks, a country can maintain the stability in the real exchange rate through the adjustment of its nominal exchange rate. Otherwise, domestic prices and wages, as well as resource mobility, must adjust.

After the liberalisation of capital account controls, monetary policy will (in theory, at least) represent a trade-off between exchange rate and interest rate policy. A floating exchange rate regime should allow the central bank to retain a degree of autonomy in setting monetary policy by deciding domestic interest rates according to domestic economic fundamentals.

However, the requirements for a successful floating system are also rather demanding. For China, success mostly requires related reform measures in money and capital markets, as well as banking sector restructuring and changes in corporate governance. Top priority should go, perhaps, to hardening the budget constraints of state-owned banks and enterprises. Otherwise, enterprises and banks will be unresponsive to monetary policy signals, and the transmission of monetary policy will be ineffective. In addition, the central bank needs to reduce the potential damage of excessive currency risks through prudential regulations that limit the open foreign exchange positions of state-owned banks and other state-owned enterprises.

Under a floating exchange rate system, capital controls will need to be eased and the money market will need to be developed. Interest rate flexibility, in particular, is important as the determination of exchange rates under a floating regime is influenced greatly by domestic interest rates and cross-border capital mobility. When the interest rates are decided by the central bank, they do not necessarily reflect the market's demand and supply of capital. Currently, the PBOC sets lending and deposit rates for all categories of capital in domestic currency, and Chinese banks are only allowed to make loans or offer interest on deposits within a certain band of the official rate (rural cooperatives now have more room to manoeuvre).⁹

The central bank usually decides monetary policy rules in a floating exchange rate system. Inflation targeting, for example, enjoys great popularity as an optimal monetary rule, even among emerging economies. Schaechter-Stone-Zelmer (2000) observe, "The experience of these countries suggests that the foundations for successful, full-fledged inflation targeting are built on the following: a strong fiscal position and entrenched macroeconomic stability; a well-developed financial system; central bank instrument independence and a mandate to achieve price stability; a reasonably well understood transmission mechanism between monetary policy actions and inflation; a sound methodology for constructing inflation forecasts; and transparency of monetary policy to build accountability and credibility."

Obviously, some of these foundations are quite fragile in China's case. A floating exchange rate system requires relatively developed domestic financial markets. A flexible exchange rate system and liberal capital control regime will not necessarily prevent 'hot money' capital inflows that push the real exchange rate to levels that cause problems in the domestic economy. When the domestic market is underdeveloped, the central bank can lose control of domestic money since it is generally difficult to sterilise.

3.4 Intermediate arrangements: the crawling peg and floating within a band

The RMB's fate after China joins the WTO is hard to predict. On one hand, an influx of foreign direct investment and portfolio capital will contribute to RMB strengthening. On the other hand, the relaxation will encourage spending of foreign currency and allow a possible current account deficit driven by booming domestic investment. China will very likely see large service trade deficits, as many formerly restricted service areas are opened to foreign firms and individuals. To maintain external balance, China's exchange rate will likely require periodic adjustments.

The advantage of intermediate arrangements is that they combine benefits of both peg and floating systems. For example, a crawling peg allows a country with a history of high inflation to enjoy a relatively stable currency and avoid real exchange rate overvaluation. Wide-band systems give countries flexibility in dealing with shocks and avoiding wide swings in currency value.

There are also distinct shortcomings to these intermediate arrangements. Soft pegs, in particular, have limited credibility and are poorly suited to dealing with large shocks. They are vulnerable to speculative capital flow and currency attacks. Since the EMS crises, repeated currency crises in a number of countries have signalled a strong warning sign against the soft peg exchange rate regimes. Currency and financial crises repeatedly indicate that exchange rate regimes between hard pegs and free-floating regimes are unsustainable. Flood and Rose (1997), and Obstfeld and Rogoff (1995), both observe that pegs are never permanent solutions.

It is also a non-trivial task to establish crawl rules for a crawling peg system. A backward rule that extrapolates from past inflation may sustain inflationary inertia, while a forward-looking rule may be based on little more than wishful thinking. For a wide-band system, the selection of the bands has equally large implications. In general, wide bands provide the central bank with room to deal with shocks, while narrow bands restrict exchange rate fluctuations.

A system of floating within a band might be appropriate for China during the initial period of transition. China has very low inflation at present and the PBOC has gained considerable credibility in containing inflation in recent years. Floating within a band also provides the benefits China needs most. China needs time to develop domestic financial markets and give domestic enterprises and banks a chance to learn to deal with the challenges of international capital mobility.

Finally, while wild swings in exchange rates hinder the healthy development in the financial market and expose enterprises and banks to risk, the freedom to deal with shocks is necessary for economic evolution. Eichengreen et al (1998) show that the exit from a peg under capital controls is best undertaken when the currency faces no depreciation pressures and the country enjoys a favourable net capital flow situation. As China satisfies both of these conditions, a gradual widening of the target band for the RMB seems to be a viable choice for China during the initial transition period. This should be closely linked to the pace of other measures to relax capital controls.

4 Liberalisation of capital controls in China

4.1 Capital controls still needed

Capital account controls can help compensate for the imperfections of domestic markets and market players. They can also restrain the consequences of excessive fluctuations and allow a degree of independence in domestic monetary policy. As China seeks both a stable exchange rate and a domestic-oriented monetary policy (China's monetary policy clearly seeks to deal with more than just inflation), some capital controls are inevitable. Rodrik (1998) convincingly rejects the hypothesis that liberalisation of capital controls improves economic efficiency. Conversely, capital controls do not necessarily hinder economic growth.¹⁰

4.1.1 The "second-best" argument

In a well-functioning free market economy, free mobility of capital is indispensable to systemic efficiency. Capital controls help compensate for imperfect markets, particularly ones with asymmetric information structures and immature financial markets and market players. This is the "second-best" argument.

Chinese physical and financial markets still require considerable development. Money, capital and foreign exchange markets were established only recently. The main agents in these markets lack proper internal control mechanisms. State-owned banks and other state-owned enterprises are characterised by a lack of effective governance, soft budget constraints and blurred ownership structures. Extensive irregularities and irrational behaviour on the part of enterprises and banks have been revealed in recent years. In circumstances where actors in the market lack the possibility to adequately assess financial and exchange risks, over-borrowing tends to be the most likely consequence. The subsequent financial collapse of such over-extended enterprises and banks threatens financial and macroeconomic stability.¹¹

4.1.2 Increased financial risk in the financial system.

China has an elaborate and comprehensive capital control system to protect the exchange rate from the effects of unwanted capital flows. Capital account controls in China have so far insulated China's domestic financial markets from the influences of international capital movements, but, as noted, China still needs time for its domestic financial markets to evolve and for domestic enterprises and banks to learn to handle the challenges of international capital mobility. The financial supervisory authorities also need time to strengthen their supervisory capabilities, to build up prudential measures to counter over-borrowing and exchange risk, and to prevent domestic capital flight.

If progress does not continue on these fronts, the relaxation of capital controls becomes quite risky. Recent catastrophes from the relaxation of capital controls include the currency and financial crises in Finland and Sweden in 1991-92, in Mexico in 1994, and in Thailand and Korea in 1997. All these crises in some way involved liberalisation of capital controls. During the Asian financial crisis, China stayed immune from contagious speculative attacks on its currency. One argument is that China was spared from crisis because of its tight controls on capital flows. Certainly, the problems in China's financial sector at the time were no less

severe than in other countries hit by the Asian crisis. The lessons of the Asian crisis should make China's policymakers very cautious on the subject of lifting capital account controls.

In any case, capital control regimes will always have loopholes and irregularities that let some parties evade controls. In China's case, ITICs borrowed extensively from abroad in the early and mid-1990s. Many of these foreign loans were never approved or even registered nor registered with SAFE. On the other hand, widespread irregularities may also indicate that controls by themselves are insufficient to prevent balance-of-payments problems.

4.1.3 Assistance for monetary and fiscal policies

To a country like China with previously closed capital market, the liberalisation of capital accounts introduces tremendous challenges to the monetary policymaking. The simultaneous tasks of smoothing any wide fluctuation in the currency value and conducting autonomous monetary policy will perhaps be the biggest challenge for the PBOC.

China's fiscal policy has been rather expansionary in recent years. The resulting fiscal deficits have been financed mainly with government bonds. As long as capital controls are in place, the government does not need to worry about the exchange risk premium and can depress domestic interest rates. With cross-border capital mobility, it becomes nearly impossible to maintain a stable wedge between domestic and foreign interest rates while reducing pressures on a fixed exchange rate.

4.2 The need to ease controls

With WTO accession, China's capital control regime must ease. The relaxing of capital controls will promote development of domestic financial markets and institutions by enforcing hard budget constraints and promoting competition. In its WTO negotiations, China agreed to substantial tariff cuts on industrial and agriculture products, as well as significant concessions on foreign entry to service sectors such as the telecommunications, insurance, banking, securities, audio visual, tourism and professional services. The significance of this all-out opening policy will be discounted if there tight capital account controls remain. Foreign banks will use their RMB sources for carrying out their activities as long as they are unable to absorb local deposits and there are restrictions on converting their own foreign exchange assets into RMB assets.

The choice of exchange rate regime also has a bearing on capital controls. The current capital control regime fits the fixed exchange rate policy. However, once China moves to a flexible exchange rate policy in the medium term such as floating rate policy, RMB convertibility under current accounts is generally inadequate. Furthermore, the Chinese government's long-term goal to have full convertibility of the RMB also argues for eventual relaxation of the current capital control regime.

4.2.1 China's opening policy and integration into the global economy

The Chinese economy has been rapidly integrated into the global economy. Since China opened to the world in 1979, it has experienced tremendous growth in foreign trade and FDI utilisation. In 2000, foreign trade accounted for over 45 per cent of GDP and FDI utilisation equalled 4

per cent of GDP. On an accumulated basis, FDI equalled 40 per cent of China's GDP in 2000. From the Chinese experience, the benefits of full integration into the global economy far outweigh the costs.

However, as a country becomes increasingly involved with the global economy, capital controls become distorting and ineffective. They cannot prevent financial crises when domestic monetary policies are inconsistent with economic fundamentals. A rigid capital control regime is incompatible with integration into the global economy, not least due to the increasingly large costs related to capital controls. As experiences of OECD countries show, free capital flows facilitate trade and investment and are efficient in the long term.

4.2.2 Current difficulties in the capital control regime

China's current system of capital account controls has already begun to show cracks, including the following difficulties for various institutions.

- **Designated commercial banks**

The branches of designated foreign exchange banks must prepare for foreign exchange buying and selling by their customers, meaning that they have to keep both foreign exchange and RMB reserves for foreign exchange related trades. Since only the headquarters of each bank trade in the foreign exchange centre, branches of each bank will have to balance their need within the bank first. Only after the consolidation of foreign exchange balances does the head office enter the foreign exchange trading centre. When there are large buy and sell orders, branch offices often have difficulty in handling the trades in a timely manner. Moreover, banks often lack the means and resources to check the authenticity of trade documents. False trade declarations are apparently common, and significant amounts of trades in foreign exchange are based on faked documents that have nothing to do with actual export or import business. This aggravates the capital flight problem.

- **Domestic enterprises**

Under the compulsory foreign exchange settlement system, domestic enterprises must surrender their foreign exchange earnings. This leaves them unable to adjust their foreign exchange holdings to deal with even small, routine needs. Enterprises always must also produce proof of their need for foreign exchange. The paperwork is often tedious and is liable to foreign exchange risks. Large Chinese enterprises with global business activities already require easy access to and autonomous disposition of foreign exchange. In a long run, the current capital control regime will hinder Chinese enterprises from adopting global strategies.

- **The PBOC**

In recent years, only about a fifth of China's current account surplus was reflected in the increase in foreign exchange reserves. Rampant capital flight is evidenced by the huge numbers of the errors and omissions in China's balance-of-payments statistics. Further, virtual pegging of the RMB forces the central bank to intervene in the foreign exchange markets. Typically, the PBOC does over 25 per cent of total trading. Sometimes this share exceeds 50 per cent.

4.2.3 Liberalisation of financial market inevitable

The liberalisation of money and capital markets is tightly linked to the liberalisation of foreign exchange market. Currently, China's money markets and capital markets are separated from international markets. This situation will change after China joins the WTO.

- **Money markets**

Interest rate liberalisation is high China's financial reform agenda. Interest rates in the inter-bank money market, as well as loan rates, need to be determined by the market, since these rates have important implications on the determination of the exchange rate.

The demands of portfolio management and effective participation of foreign banks in China's financial markets also call for flexible foreign exchange control. If capital account controls are lifted too early, the impacts of international capital market will adversely affect development of domestic money markets and restrict monetary policy. On the other hand, development of domestic financial markets will also be hampered by overly tight capital controls.

- **Capital markets**

While China's domestic stock markets need foreign investment, such ill-fated experiments as the creation of a B share market for foreigners show the need for broader thinking on the matter. Moreover, most state-owned enterprises still find it too demanding to seek listings on international exchanges.

China established a two-tier market that limited foreign investors to the purchase of B shares of about 80 companies that were also listed on the domestic A share market. This market never generated much interest, as the firms were small, illiquid and state-owned. At the end of 2000, the total market capitalisation of B shares was only about USD 7 billion. These B shares typically traded at a more than 70 per cent discount compared to A shares. Recently, the Chinese authorities opened this market to domestic investors with legitimately acquired foreign exchange. The next logic step is to merge A and B markets. In addition, the authorities have indicated an interest in introducing a system similar to Taiwan's Qualified Financial Institutional Investor (QFII) system. Both steps require a flexible foreign exchange control regime. Such developments could have profound consequences for capital controls.

- **The foreign exchange market**

The compulsory foreign exchange settlement system and other regulations suppress supply and demand for foreign exchange. As a result, enterprises and banks find it difficult to ascertain their optimal foreign exchange positions. Moreover, designated foreign exchange banks are limited by foreign exchange quotas set by SAFE. As there are strict controls on foreign borrowing, the total amount of foreign exchange in the market is limited, and largely dictated by the current account situation. Since China enjoys current account and capital account surpluses, the supply of foreign exchange has tended to exceed demand. The resulting appreciation pressure on the RMB compels the PBOC to buy large amounts of foreign exchange to stabilise the exchange rate.

4.3 Liberalising capital controls

As mentioned, improper relaxation of capital controls can have serious consequences – and even precipitate a major financial crisis. Thus, liberalisation of China's capital control regime has to proceed with the development of the financial markets and the exchange rate policy. A gradual approach enables the policymaker to monitor and control risks during the process.

Fischer (2001) suggests the following approach. "Where controls on capital outflows are reasonably effective, they would need to be removed gradually, at a time when the exchange rate is not under pressure, and as the necessary infrastructure – in the form of strong and efficient domestic financial institutions and markets, a market-based monetary policy, an effective foreign exchange market, and the information base necessary for the markets to operate efficiently – is put in place. Unless the country intends to move to a hard peg, it would be desirable to begin allowing some flexibility of exchange rates as the controls are gradually eased. Prudential controls that have a similar effect to some capital controls, for instance limits on the open foreign exchange positions that domestic institutions can take, would also be put in place as direct controls are removed."

China's first step could be the gradual phase-out of the compulsory foreign exchange settlements. A voluntary system would be introduced incrementally in a way that reflects the exchange rate needs and expectations. This would also help strengthen the role of China's current foreign exchange market in determining the exchange rate. Of course, this step should be accompanied with a hardening of budget constraints of state-owned banks and enterprises, as well as the capability of the policymakers to monitor and supervise capital flows. Finally, easing of the capital account controls should be coordinated with interest rate liberalisation.

5 Conclusions

A fixed exchange rate policy does not necessarily conflict with WTO accession. However, in China's case, the resulting liberalisation of trade and investment will inevitably increase shocks to the domestic economy. More importantly, WTO membership will force changes to China's current capital control regime.

Underdeveloped financial markets and financial institutions are particularly susceptible to wild fluctuations of exchange rates and overflows of capital. Due to market imperfections and inexperienced market players, currency stability is important before attempting the transition to liberal capital account transactions. Thus, a pure floating of the currency is not a viable choice for China in the near future. Liberalisation of capital controls needs to consider both exchange rate policy and the state of financial market development. They should provide China with time to develop its domestic financial markets and give domestic enterprises and banks a chance to learn to deal with the challenges of international capital mobility. The financial supervisory authorities also need time to strengthen their supervisory capabilities. Thus, some sort of capital control measures could be temporarily utilised in conjunction with flexible systems, e.g. soft pegs that limit currency movements or a managed float within a wide band. Contrary to conventional wisdom, these intermediate arrangements between a peg and a free-floating system could be quite useful for China in the medium term.

Eventually, of course, China will become integrated into the global economy and its financial markets will have developed. At that point, a flexible foreign exchange regime, i.e. a managed floating exchange rate system with capital account convertibility is appropriate. This conclusion is based on the following three considerations.

First, China already has a large economy – and it continues to grow rapidly. In PPP terms, China is the second largest economy in the world after the US according to both the World Bank and the OECD. Large economies typically opt for a floating exchange rate policy.

Second, China's increasingly open economy and the need to enhance financial market efficiency demand liberalisation of capital market controls. As capital controls lose their effectiveness, the liberalisation of capital controls becomes inevitable. While these inter-medium arrangements are vulnerable to currency crises and not viable over the long term, certain types of floating systems seem the best candidates.

Finally, China's accession to the WTO will increase nominal shocks such as capital flow shocks and real shocks such as trade and unemployment shocks. To maintain high economic growth and external balance, China's exchange rate will likely require periodic adjustments. A managed floating exchange policy can both mitigate shocks and maintain real exchange rate stability without real adjustments of domestic prices and wages. Independence in conducting monetary policy is essential to dealing with such shocks.

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Notes

¹ RMB is the standard abbreviation in China. Internationally, the ISO currency code is CNY.

² Calvo and Reinhart (2000) report that the disparity of official and actual practice is common in many developing countries.

³ There were fluctuations in 1994 and 1995, as the exchange rate gradually appreciated from an initial rate of RMB 8.7 to the dollar at the beginning of 1994. However, after 1995, and particularly during and after the Asian crisis, China's exchange rate has remained within a narrow band.

⁴ A few large SOEs were permitted to retain up to 15% of their foreign exchange earnings from the previous year.

⁵ Future development of foreign exchange market needs to emphasise non-physical markets. Telecommunications and networking technologies facilitate decentralised trading. Foreign exchange brokerages can be introduced, and market players should be able to determine the foreign exchange deals in a bilateral basis, in addition to the centralised trading.

⁶ In China, only the PBOC offers foreign exchange futures to its customers. The futures are limited to seven currencies for 13 different maturities under 120 days. Much more efforts are needed to develop new products in the foreign exchange market, such as foreign exchange future and options, and introduce more hedging methods.

⁷ A currency basket may be an alternative here.

⁸ See e.g. Obstfeld (1994, 1997), Jeanne (2000).

⁹ In the latter part of 2000, the PBOC announced its intention to relax interest rate controls. The PBOC said it would first liberalise interest rates on foreign currencies, then the RMB; first loans, then deposits; first rural areas, then cities; first wholesale, then retail businesses.

As a first step, the PBOC authorised banks to determine their foreign currency lending rates and foreign currency deposit rates for deposits over USD 3 million. (Rates on deposits under USD 3 million are decided by the China Banking Industry Association). In the next step, PBOC will allow inter-bank and securities market rates to fluctuate freely. In the third step, the PBOC will permit the liberalisation of interest rates on large, fixed-term deposits. All these are scheduled for implementation within the next three years. However, full liberalisation of interest rates on other deposit accounts will be postponed, as the PBOC is worried about the consequences of full liberalisation of deposit rates that could include cut-throat competition for deposits and financial instability of state-owned commercial banks

¹⁰ Using different data sets, Quinn (1997) and Edwards (2001) find evidence to support the correlation between liberalisation of capital controls and economic efficiency- They find that they are more closely linked in developed countries than in developing countries. See also the survey of Arteta-Enchengreen-Wyplosz (2001).

¹¹ Obstfeld (1998) provides a lively discussion on whether the global capital market is a benefactor or menace.

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